Grout, Paul A. "Fostering Supply Side Markets for Public Services." *Public Services: A New Reform Agenda*. Ed. Henry Kippin, Gerry Stoker and Simon Griffiths. London: Bloomsbury, 2013. 109–126. *Bloomsbury Collections*. Web. 26 Apr. 2023. <<http://dx.doi.org/10.5040/9781472544872.ch-007>>.

Downloaded from Bloomsbury Collections, www.bloomsburycollections.com, 26 April 2023, 13:01 UTC.

Copyright © Simon Griffiths, Henry Kippin and Gerry Stoker 2013. You may share this work for non-commercial purposes only, provided you give attribution to the copyright holder and the publisher, and provide a link to the Creative Commons licence.

Fostering Supply Side Markets for Public Services¹

Paul A. Grout

The private sector's involvement in the delivery of public services has grown enormously in the last 30 years. The 2008 Department for Business, Innovation and Skills (BIS, formerly BERR) Public Services Industry Review estimated that the turnover of the industry in the UK was £79 billion in 2007/8. Globally it is estimated that 18 per cent of the global stock market value and 39 per cent of the non-US total value (Megginson, 2005) consist of assets that have been transferred from the public sector to the private sector in the preceding 20 years, a significant proportion of which consists of public services. Within developed economies, privatized companies account for a significant fraction of the stock markets: more than 13 per cent in Germany and nearly 12 per cent in Australia (Megginson and Netter, 2001), most of which are public services. Over 1,000 'public-private partnership' (PPP) projects – again mostly public services – had reached financial closure in the European Union alone by 2007, with a total capital investment of around €200 billion (Blanc-Brude *et al.*, 2007).

Clearly the supply side has delivered sufficient providers from the private sector to make this possible and in the immediate future spending restrictions are such that constraints in the private markets are unlikely to appear. However, this does not mean that over a longer period private suppliers will either maintain their position or be available if growth of private involvement in the delivery of public services continues.

This chapter identifies different models of private delivery, and addresses the benefits that the private sector suppliers bring, with a view to indicating where long-term growth in the market may arise. A crude but useful taxonomy

¹ This paper, written in June 2010, draws from my keynote address at the European Commission's Eurosocal Taxation Conference, Mexico, 24–8 November 2008.

is given which boxes non-public provision of public services into three main categories: (i) full privatization (essentially an arm's-length relationship between provider and government), (ii) public-private partnerships (separated again into outsourcing partnerships and private finance initiative arrangements); and (iii) not-for-profit. The comparative merits of these three are explored through the answers to a series of questions: when are private incentives likely to be beneficial, how does pro-social motivation impact on whether we should be fostering for-profit or not-for-profit, and should we be fostering more long-term partnerships or arm's-length relationships? The general theme that emerges is that, on average, privatization and outsourcing partnerships have been successful. Private finance initiative partnerships appear to have brought benefits, but it is difficult to be certain. In contrast, the view that not-for-profit is a superior to for-profit delivery appears unproven.

This picture suggests that the private sector has a significant and growing role to play in the delivery of public services. But things are not this straightforward. The reason is that the empirical evidence runs totally counter to public opinion. Surveys and focus groups show that private delivery is greeted with scepticism by the public. There appear to be two problems (although these are really the same thing viewed from two different angles). The public seem to think that private provision lacks the public service ethos that is deemed to be essential and that the profit motive is unacceptable in public services. In contrast not-for-profit delivery has been growing rapidly and is perceived in a positive light. This conflict between what private delivery has to offer and what the public think of it and want from it is probably the biggest constraint on the growth of private delivery mechanisms.

The public sector, public services and public services industry

To map out the sphere of private involvement in public services, it is important to distinguish between the 'public sector', 'public services' and the 'public services industry' (though it is difficult to provide watertight definitions of these things).

The public sector comprises the economic activities controlled by the government. A legitimate concern is that the public sector is not subject to the discipline of the competitive market and may lack incentives to control costs, provide good quality service and respond to customers' needs. Hence, what is the appropriate sphere of the public sector and which sector should

deliver which public services is a critical question. As a working definition, this paper takes public services to be the set of services provided for large numbers of citizens in which there are potentially significant market failures (broadly interpreted to include equity as well as efficiency) that justify government involvement, whether in production, finance or regulation (Grout and Stevens (2003). The public services industry has been defined by the Public Services Industry Review (2008) as 'all private and third sector enterprises that provide services to the public on behalf of Government or to the Government itself'.

What's in and what's out of these three definitions is a little blurred at the edges, but the definition of public services clearly includes utilities, transport infrastructure, most education and health services, street cleaning and rubbish collection, and national defence.

The terms 'public sector', 'public services' and public services industry' are not aligned. Not everything that the public sector does is a public service – for example, helping to promote the efficiency and exports of private sector industry is not a public service in the sense used here. It may well be a public sector activity and if provided by private companies to the relevant government department it would be part of the private services industry. Similarly, many services supplied in some countries by the private sector are unambiguously public services – for example, water supply and electricity distribution.

A crude taxonomy

Although the role of the private sector is diverse and there are numerous delivery 'mechanisms', most non-public delivery can be loosely categorized into one of three (overlapping) models: (i) full privatization, (ii) public–private partnerships, which are partnerships between the private and public sectors, (iii) and heavily restricted legal forms of organization, which in practice mostly boil down to non-profit organizations.

Full privatization

The defining characteristic of full privatization is that the government's role is 'arm's-length'. Ownership is fully transferred to the private sector. The newly created private company recovers most, if not all, of its revenues from the general public and private sector customers and the government's involvement is, at least in theory, thereafter limited to setting up regulatory agencies and keeping a watching brief on the objectives to which the regulator is to be held

accountable. This model has been very common around the world for big utilities such as telecoms and energy and, to a lesser extent, water and transport. Of course, in many cases, the transfer of ownership is more apparent than real, since companies often operate under a licence from a regulator. Although a company may legally have full ownership of its assets, the assets are of limited use if the company does not have a licence to sell the service.

The full privatization model still allows scope for political pressure and corruption, which in many countries causes problems for investment and growth. It is not surprising therefore that the independence of the regulator and the general level of corruption in an economy have turned out to be important elements in determining the success of the approach. Furthermore, because of the scale of the infrastructure involved, these companies tend to be placed on stock markets or put out to the world's capital markets. So the full privatization model has become forever intertwined with political sensitivities about stock markets, global capital markets and, particularly in developing countries, the development of their own financial markets (see, for example, Grout (1997, 1994).

Public-private partnerships

For other services governments have chosen to maintain a more direct relationship with the private sector or to continue to provide many public services themselves. There are many reasons why they might do this. The nature of the services may make the full privatization model impractical – for example, an integrated urban road network, poverty may make it impossible to charge economic tariffs, sometimes the only purchaser is the government itself – for example, defence or, in many economies, healthcare and primary education services, the government may face anti-privatization political pressures from workers or the electorate.

In any of these circumstances, the government may end up having a far more intimate, complex, continuing and subtle relationship with private providers. These partnerships tend to be either *outsourcing-type partnerships* – where services are provided on short- or medium-term contracts – or longer-run *private finance project partnerships*. PPPs are not partnerships in the way that lawyers, professional service providers or private companies understand the term. All exchanges take place under a clear contractual relationship and there is clear ownership of all assets.

There is an element of truth in the idea that the global public was sold privatization by governments as if it was a panacea for all public sector sins,

and the public have since found that this could never be the case. As a result, the word privatization is now met with more scepticism. For politicians and non-governmental organizations, it carries a tarnished feel that the word partnership nimbly sidesteps since it suggests more of a closely balanced relationship than is really present.

The evidence on outsourcing partnerships is well documented. In contrast, there is far less evidence on PFI partnerships and they remain highly controversial. Nevertheless, there has been a large global shift towards their use. The International Monetary Fund (IMF) has described PPPs as ‘a wave that is sweeping the world’ (IMF, 2004). This may be slightly overly enthusiastic but indicates the scale of what is happening.

Not-for-profit

While the profit motive and its consequences are generally considered a central plank of what the private sector has to offer, they are not essential. Private legal forms can be set up with all sorts of restrictions on what they can and cannot do. Setting up an organization in a way that prevents the distribution of profit to shareholders is relatively common. It is then a moot point whether a not-for-profit organization is really part of the private sector or a sector in its own right (often referred to as the third sector). There is a vast theoretical literature on the potential benefits of such structures though it is yet not matched by empirical research. Not-for-profit organizations play a major role in delivery of public services in the USA, and despite the mixed evidence there is a clear sense that governments are likely to increasingly turn to this model, in part because of popularity of the sector with the public.

When are private incentives likely to be beneficial?

Here I focus on two messages. These arise from the answer to an obvious question – why should it matter which sector delivers services? Or to put it another way, why can’t the public sector replicate the most beneficial aspects of the private sector and vice versa?

One view, which we can think of as the direct effect, is that the primary reason stems from incomplete contracts. Contracts tend to be incomplete for all sorts of reasons. For example, some activities may be important but too nebulous to specify in a contract. Even though the parties involved may be able to identify accurately what is happening it may not be possible for a third

party (e.g. a judge) accurately to observe or for other reasons it may be too difficult to define in a watertight legal way. Another obvious reason is that the potential outcomes may be too numerous and vague to categorize or at least too numerous to write into a contract without incurring onerous transaction costs.

If contracts are incomplete, then it will not be possible to describe fully what actions agents and the owner of an asset should make in every possible situation. So the owner of an asset is likely to have some flexibility over outcomes when the other party would prefer this not to be the case, and even when assets are not significant contractual silence on issues conveys power to different parties according to the nature of the service. This will be a more significant issue the harder it is to cover critical issues within a legal contract. Incompleteness of contracts may be a particular problem with public services since the service is often difficult to define completely. For example, it is difficult to define the quality of care that should be administered in particular situations and hard to prove legally that someone is not doing enough in different situations.

Where contractual incompleteness is a significant issue and cost reduction reduces quality, then how much cost reduction there will be may depend on the sector that is doing the delivery – that is, which sector owns the assets and the ‘production’ process. If a profit-maximizing private company owns the assets, then the company may choose to reduce costs regardless of the consequences for (non-contractible) quality reductions. In contrast, the public sector will care about quality as well as cost, taking account of any effect of quality reduction when reducing costs – so quality should be higher and cost reductions lower. But the public agent is harder to motivate to reduce costs even when it has limited effect on quality.

The net effect is that the private sector is more likely to provide lower costs but lower quality. This simple reasoning provides a clear implication: where the social cost of reductions in non-contractible quality reduction is large relative to potential cost savings – for example, brain surgery – then public provision has benefits. Where the social cost of non-contractible quality reduction relative to potential cost savings is less of a problem – for example, emptying dustbins – then private provision is likely to bring benefits (e.g. Hart *et al.*, 1997; Shleifer, 1998).

The other view I wish to emphasize suggests that the prime value of involving the private sector stems from the difficulty of introducing competition in the public sector. The argument is that limited competition makes the public sector expensive and hence the private sector has a role to play as the enabler of competition.

There is considerable evidence that competition has a cost-reducing effect, but there are limitations to the services to which it can be applied. For competition to be real, there has to be a genuine fear of termination of contract for the incumbent. Indeed, the big advantage of using private suppliers is that it is practically and politically easier to remove underperforming agencies. But the process is only suitable where changing supplier is practical. If there are significant costs of transfer, then the incumbent is in a strong position and the competitive framework can unravel. If a government threatens to replace a supplier but the costs of replacement are high, then, when it comes to it, the government may not follow through their threat – the threat of replacement is said to be ‘time inconsistent’.

Competition may have a big impact on some services, such as refuse collection, since if things go wrong during transfer, then bins may be emptied haphazardly for a short while but this is an inconvenience not a major problem. But this is not true for many public services. For example, with gas or electricity transmission or railways, there may be real dangers with transfer of contracts.

Generally, the evidence on the impact of outsourcing on costs is very clear. For example, Domberger *et al.* (1986) looked at refuse collection in 305 local authorities and found that where the service was put up for tender and given to a private operator, there were average cost savings of 22 per cent (after allowing for differences in service factors that would have affected cost). It is possible that this could have been due to sample selection effects – notably that the authorities that put their waste collection up for tender were those that thought they were paying too much for the services. Szymanski and Wilkins (1993) show this is not the case: they find savings of approximately 20 per cent after the introduction of compulsory competitive tendering in local government. Using data from 3,000 hospitals in the UK, Domberger *et al.* (1987) find savings of 34 per cent from competitive tendering for hospital domestic services.

So the private sector effect is present but is this effect direct or indirect? Several studies address the question of whether the price falls are greater if a private sector company wins a bid compared with the situation where the public sector incumbent wins. Most studies found no direct sector effect – for example, Domberger *et al.* (1986, 1987), Dijkgraaf and Gradus (2003) and Milne and McGee (1992). But Szymanski (1996) reported that if a local authority awards the tender to their in-house team, then costs are reduced by about 10 per cent compared with a 20 per cent cost reduction with private contractors. Using Italian procurement cases, Bandiera *et al.* (2008) also found a sector effect. Other studies using different approaches also suggest that competition is a key

driver. Coviello and Mariniello (2008) looked at Italian procurement and the effect of publicity laws. Using evidence from over 40,000 procurement auctions, they showed that increasing publicity from local to regional increased bidders by 50 per cent and reduced the price paid by 5 per cent. Increasing publicity to the European level had no effect on the number of bidders but reduced the price paid by an additional 10 per cent.

Bel and Costas (2006) suggest that the benefits of contracting out may decline over time, and Ohlsson (2003) found that public production is only 6 per cent cheaper than private production. There are insufficient recent studies to know if there is a time effect but it is not implausible. As outsourcing develops, then more public sector suppliers realize that they may become exposed to these competitive forces. The probability that this will happen will itself be sensitive to the performance of the public supplier since the worse it is, the more probable a government will turn to outsourcing. So it would not be surprising to find public delivery improving over time even for services where outsourcing is not formally present. Of course, this does not mean that the benefits from having outsourcing, relative to a situation where outsourcing could never arise, are reduced. It is simply that the growing threat of outsourcing is enough to bring about some of the benefit through better public delivery. So when the sector actually is changed, the net effect is less since part of the gain is already in the public cost figures.²

But it appears that much of this effect operates through competition rather than there being something unique about the private sector that makes it inherently cheaper. There is some evidence that the sector effect is present but it is not the biggest part of the story.

Pro-social motivation: Should we foster for-profit or non-profits?

Individuals may care about the activities in which they are involved beyond the financial rewards that they receive. In the context of public services, this is sometimes called public service motivation – the desire to work in public services to contribute to output and quality. More generally, this can be thought of as pro-social motivation (Francois and Vlassopoulos, 2007). Pro-social

² There is little evidence showing that quality falls if the private sector takes over an activity. For example, Domberger *et al.* (1995) undertook a careful analysis of 61 cleaning contracts and found that cleaning performance was either maintained or improved.

motivation can lead to pro-social behaviour such as ‘donated labour’ – labour donated beyond what is explicitly or implicitly contractually required – but this may depend on the type of organization that employs the motivated individual.

The idea that not-for-profits may be better at encouraging employees and management to display pro-social behaviour than for-profit organizations stems from the work of Arrow (1963), Hansmann (1980), Easley and O’Hara (1983) and Rose-Ackerman (1996). In this literature, not-for-profits generate a trust signal – that is, not-for-profit suppliers will not reduce quality even though they are not contractually bound to a specific standard. The idea that not-for-profit organizations elicit pro-social behaviour has been formalized in a series of papers by Francois (2000, 2001, 2003, 2007). The analysis rests on the inability to contract fully over all outcomes.

Consider a hospital where all employees have pro-social motivation and, by way of example, decide that they will never leave a shift if there is no-one else at hand to take over. The commitment of the staff to stay if needed protects a for-profit employer from negative outcomes, including potential legal redress, if there is a staff shortage, and so a for-profit company will find it hard to pre-commit not to take advantage of this by hiring fewer employees than before. Of course, the employees will realize this and so will not ‘go the extra mile’ because their donated labour does not improve the quality of patient care. So the for-profit form is unable to deliver the preferred outcome – it cannot prevent itself from diverting donated labour if it arose and so any desire to offer any is diluted or destroyed completely. In contrast, in a non-profit organization, the non-distribution constraint prevents this expropriation and so the donated labour does indeed improve the outcome of the business. Employees who are motivated therefore have an incentive to donate labour. This literature suggests that donated labour will be positively associated with not-for-profit and government organizations, and absent or limited in for-profit organizations.

An alternative ‘mission-matching’ approach (most clearly formalized by Besley and Ghatak, 2005) also identifies when the profit motive may be inappropriate. In this model, individuals have particular missions, which motivate them to engage in pro-social behaviour. The mission – and the associated behaviour – is a fixed individual characteristic, but people will be attracted to like-minded organizations, so that mission-oriented organizations that favour high quality public service provision will attract employees whose personal mission matches this. The core distinction is between mission-oriented and profit-oriented organizations, and the approach suggests that, in some circumstances, profit-oriented organizations may perform less well than mission-oriented ones

because they will not attract mission-oriented individuals. So the profit motive may be less effective where individuals have strong pro-social missions and this raises a question as to whether we wish to promote non-profit organizations rather than for profit.

There is a significant literature looking at the comparative performance of not-for-profit and for-profit firms, much of which looks at US not-for-profits since these are well established, notably in health. Despite the appeal of arguments suggesting that not-for-profits should have clear advantages, it is hard to see this effect in the evidence, which tends to be mixed. Of course, in terms of global reach, the evidence is drawn from a limited pool so further analysis is certainly needed. Research finding that not-for-profits are more efficient than for-profits includes Cutler and Horwitz (2000), Ferrier and Valdmanis (1996) and Wilson and Jadow (1982) on hospitals, and Nyman and Bricker (1989) on nursing homes. Research finding the opposite includes studies undertaken by Woolhandler and Himmelstein (1997), Becker and Sloan (1985) on hospitals, and Blau and Mocan (2002) and Mocan (1997) on day care centres. In response to these inconclusive results, Eggleston *et al.* (2006) used a quantitative meta-analysis approach to systematically review the literature on US hospital performance. They found that many of the results were driven by differences in the way that studies accounted for market variation and regional differences. Yu *et al.* (2006) found only tentative evidence for higher patient care costs and profits at for-profit hospitals.

A well-established argument for the not-for-profit form is that it provides a trust signal – essentially a third sector supplier will not cut quality in the way that a for-profit supplier may. There is some evidence of self-selection of less well-informed consumers into non-profit institutions (for example, Holtmann and Ullmann, 1991) although the proxies for less well-informed are difficult to capture well. Where competition is low, not-for-profits provide a higher level of access – for example, Mas (2008).

Analysing contracts of the UK's Department for International Development, Huysentruyt (2006) found that not-for-profit firms compete most where there are important non-contractible quality innovations and that ex-post transaction costs are higher with for-profits than not-for-profits. But not-for-profit firms are less likely to adhere to procurer's terms of reference. Not-for-profit employees and organizations may go the extra mile, but it may be in the 'wrong direction' from the perspective of the procurer. This is a bigger issue in some areas than others. For example, it is thought to be a problem with evangelical religious groups in the developing countries. The groups will potentially give more 'bangs

for the buck' in terms of commitment and effort but along with this goes the particular religious pressure that is difficult for the procurer to control. This may be another reason for the lack of positive evidence on productivity.

Simple cross-section evidence shows that there is more unpaid overtime in non-profit (public and not-for-profit) than private 'caring industries', such as health and education. At first glance such evidence would appear to prove the theoretical arguments against the for-profit organizational form when there is pro-social motivation. But Gregg *et al.* (2011) used data from the British Household Panel Survey (BHPS) to show that this need not be the case. The research confirms that there is a positive and significant correlation between sector and donated labour. After including a robust set of individual and job-specific controls, individuals in the non-profit sector are more than 40 per cent more likely to do unpaid overtime than individuals in the for-profit sector. But, by exploiting the panel nature of the data, the authors found no evidence that individuals changed their donated labour when they switched sector. Thus this data throws doubt on the validity of the theoretical arguments for not-for-profit outlined above. Indeed, the study has a negative message for analysis of not-for-profits. Although not-for-profits are clearly able to attract employees who donate labour and hence may be more efficient as a result, these employees are sucked away from other employees who may lose as a result. So any aggregate efficiency gains that might arise from extending the not-for-profit sector would have to come from the improved efficiency that could arise from having a better match of employees and firm. The employees do not appear to engage in more pro-social behaviour as a result of changing sector.

So overall, the idea that not-for-profit firms deliver something that for-profit firms cannot is not confirmed by the evidence in existing studies. Indeed, although not-for-profit firms may attract individuals that offer more donated labour, there is as yet no evidence that these individuals only provide this when they work in a not-for-profit environment. Of course, there is an enormous amount of analysis needed before these questions can be answered. But currently the limited evidence does not point to a clear not-for-profit effect and so it is not clear that economic efficiency arguments point to fostering not-for-profits at the expense of for-profit.

However, it is easy to see how not-for-profit delivery appeals to politicians who wish to appease voters who, at least globally, are sceptical of more and more privatization. But the evidence suggests that the efficiency justification of not-for-profit as a method of delivery is yet to be proved.

Should we be fostering more long-term partnerships?

A common criticism of public delivery of public services is that services are delivered late (particularly if there is a significant build or renovation element involved), costs overrun and risk is not well managed. The blame is frequently put at the door of the traditional procurement process which separates initial investments (build, renovation and general sunk costs) from ongoing maintenance and delivery. Typically with traditional procurement there are different contracts for each component. The effect is that there is limited incentive to sink upfront costs which reduce future maintenance and delivery costs. In contrast, long-term partnerships bundle contracts and have some hope of sidestepping these problems and bringing about better decisions.

The extreme examples of long-term partnerships are PFI-type public private partnerships. Here the government signs a long-term contract with a private supplier and pays for the delivery of the public service throughout the life of the contract. Thus the government pays for the service as it gets it rather than paying upfront, which is the traditional procurement model. The private contractor typically owns the physical 'asset' and makes money from the payments for the service that it generates. Essentially, the building of an asset and the delivery of services over a long period are bundled together.

A road contract is good example. The traditional public provision arrangement involves the government signing an agreement with a contractor to build a road: the government pays the contractor for the road when it is built, after which the government owns the road, maintains it and makes it freely available to the public. With a PPP, a private contractor builds and owns the road: the government pays the contractor a fixed fee for every vehicle that uses the road over, say, a 25-year contract period. Upfront expenditure by the private sector followed by long-term payments by the public sector for the service is the key theme of many PPP partnerships.

The economic argument for bundling in this way can be seen in the following example. In the traditional public provision model, builders are paid for the building and they then move on to build another. If the building turns out to be rather poor quality after many years, then the government faces a complex legal battle to prove that poor building rather than poor specification or incorrect maintenance is at fault. In contrast, in the PPP model, the government pays for the service it gets. If a road is poor quality and needs expensive repairs, then the builder pays this and also suffers loss of income if cars use other routes while the road is repaired. So if the private contractor fails to deliver the service, then

it receives no payment. The idea is that the contractor has a strong incentive to deliver on time (to start the money flowing) and to ensure good quality design and build to avoid costly repairs and failures later on.

There are, however, some obvious costs to entering long-term partnerships. If a long-term contract is signed and the public sector department wants to change something then the private sector supplier has the department 'over a barrel' and changes are very expensive. Also it is not obvious that the difference in funding costs between public and private sector simply reflects the true measurement of risk. If there is a monopoly return in the cost of finance then the private project has to be sufficiently better to justify the approach.

The contract structure of PPPs is designed to provide incentives to deliver on time to start the money flowing and the evidence suggests that this happens. For example, the National Audit Office (NAO, 2003a) surveyed the PFI construction projects up to 2002 and found they compared favourably with traditionally procured hospitals (75 per cent of which were delivered late). Mott MacDonald (2002) found similar results. There are comparable results outside the UK. A European Investment Bank (EIB) study (Thomson, 2005) found fewer time delays.

Being on time is not the same as being better value. A detailed study of 200 roads funded by the EIB (Blanc-Brude *et al.*, 2006) found that PPP projects were 24 per cent more expensive than the traditionally procured roads at contract signing. There is a sample selection issue that makes it hard to interpret the results. For example, projects that are thought to be particularly expensive might be more likely to be put out as PPPs to try to use competition to control costs. This would make PPPs look abnormally expensive. But apart from such issues, the results are statistically significant. There appears to be a large additional cost to increase the delivery on time, but the authors point out that the value of cost overruns in traditional projects is between 20 per cent and 28 per cent, suggesting that at the build stage, these PPPs are neither more expensive nor cheaper than traditional public projects. Of course, theory suggests that the building costs of PPPs should be higher than traditional public projects since the PPP contractual structure should create incentives to ensure better quality delivery over time. So as well as obtaining better delivery at no greater cost, this research suggests PPPs may be better value than expected.

But currently, as I mention later, there are insufficient data to know whether this is true. There is evidence that financial risk is passed on to contractors, though investigations are limited to specific markets. Using a large sample of

debt payments, Blanc-Brude and Strong (2007) found that spreads do indeed reflect the systematic risk that PPPs face (notably traffic risk).

Do we want to foster arm's-length arrangements?

As indicated in above an alternative way of using the private sector to deliver private services is for the public sector to step back and to use regulated private companies to operate under licence, essentially full privatization. There has obviously been a global shift in favour of this model from the 1980s onwards. The rationale for the privatization wave was part economic and part political. On the economic side, the ambition was to reduce costs and improve efficiency by replacing 'soft' public budget constraints with hard market constraints while simultaneously bolstering government coffers. On the political side, reducing the size of the state and its workforce offered the prospect of making voters more conservative and rapidly ushering in market mechanisms, particularly in transition economies, rendering a return to the old ways less probable.

Much of the evidence suggests that the privatization programme globally achieved many of its economic and political objectives. Privatization is generally, although not universally, associated with improved efficiency indicators. It is also positively associated with higher sovereign debt (Bortolotti *et al.*, 2004). The situation with public services was and remains more complex. But the general drive to raise funds and move activities rapidly to the private sector meant that those public services with good market value that could be shifted fully into the private sector were first up. This basically meant large utilities and among these the services with strong demand and market power. Telecoms were the prime target everywhere, and the vast majority of telecoms networks in the world now sit in the private sector. Energy networks followed and, in some countries, including the UK, water and rail networks were also privatized.

Meggison and Netter (2001) provide the most comprehensive international survey of studies of privatization. They conclude, 'we know that privatization "works", in the sense that divested firms always become more efficient, more profitable, and financially healthier, and increase their capital investment spending'. In the UK, Martin and Parker (1997) found that in the 1990s, telecoms firm BT achieved annual labour productivity growth of 15 per cent and British Gas achieved 6 per cent. Parker (1999a, 1999b) documented a long list of improvements in service measures in UK telecoms, gas and electricity and

water since privatization. Indeed, Pollitt and Smith (2002) showed that there were major efficiencies achieved in the early years after privatization even in the rail industry in the UK, which is generally regarded as a difficult case. Newbery and Pollitt (1997) document significant welfare gains following privatization in electricity in the UK – mainly caused by greater investment, lower prices and improved productivity. These effects are also apparent in other developed economies, for example, Galal *et al.* (1994).

Privatization is also generally beneficial in developing countries though the picture here is more mixed. Davies *et al.* (2005) identified productivity gains in most developing countries and document far more positive than negative effects for consumers, governments and investors. Campos *et al.* (2003) showed gains of 2 per cent per year in productivity in Argentina's water industry from privatization, and Estache and Kouassi (2002) found clear benefits from having private operators in Africa. But Estache and Rossi (2002) found no clear difference between public and privatized provision in Asia.

A clear message from many studies is that privatization alone does not deliver anything like the same benefits if it is not accompanied by liberalization (that is, increased competition) or independent regulation. Newbery (1997) argues that liberalization is critical in obtaining the full benefits of privatization: 'privatisation is necessary but not sufficient'. Zhang *et al.* (2002) (in 24 developing countries) and Alesina *et al.* (2005) (looking at several sectors of many OECD countries) found similar results. Bortolotti *et al.* (2001) concluded that the financial and operating performance of telecoms companies improves significantly after privatization, but that a sizable fraction of the observed improvement results from regulatory changes – alone or in combination with ownership changes rather than from privatization alone.

But an obvious question is how far the privatization model can be pushed in the delivery of public services. The privatization of the UK railways is informative here, having culminated in the first bankruptcy in the UK of a privatized utility. To some extent, the blurred incentives and responsibilities (on the side of both the regulator and the companies) were the result of the original privatization structure and have been much improved subsequently. But the problem is deeper since it was the government that decided the future of the business and the returns to shareholders, not the independent regulatory body, and the government decided that it would no longer contribute enough to keep the company afloat. If companies cannot cover all their costs from customers, then the model suffers from being too close to government and the benefits of having an independent regulator are hard to achieve.

Furthermore, keeping government at arm's length is clearly beneficial but is a common concern. This is notable in developing countries, where corrupt administrations can seek to dictate the behaviour of privatized companies. But even in the UK, government actions have had a significant impact on privatized companies even in the presence of independent regulators (Grout and Zalewska, 2006).

A major constraint on growth of private delivery mechanisms.

The general theme that emerges from the previous sections is that, on average, privatization and outsourcing partnerships have been successful. Private finance initiative partnerships have brought benefits but it is difficult to be really sure. In contrast, the view that not-for-profit is a superior to for-profit delivery is unproven. This picture suggests that the private sector has a significant and growing role to play in the delivery of public services. But things are not this straightforward.

The reason is that the empirical evidence runs counter to public opinion. Surveys and focus groups show that private delivery is not popular. For example, in-depth research by Ipsos MORI for the 2020 Public Services Trust showed that:

The idea of private provision of public services tends to be greeted with suspicion. In general, alternative service provision by the private sector is rejected by many, both because the remit of private provision is perceived to lack a public sector ethos and because the profit motive is usually considered unacceptable in public services. (Ipsos MORI for the 2020 Public Services Trust)

In contrast not-for-profit delivery is growing rapidly and is perceived in a positive light. Since 2000 the voluntary sector's statutory income has grown much faster than public spending (although expenditure on the voluntary sector is still only around 2 per cent of government spend).³ In contrast to attitudes to the private sector, Ipsos MORI found that many people felt strongly that the voluntary sector should have more of a role in achieving social outcomes (although the public has relatively little knowledge of the sector).

This conflict between what private delivery has to offer and what the public think of it and want from it is probably the biggest constraint on growth of private delivery mechanisms.

³ The UK Civil Society Almanac 2010, see online at <http://www.ncvo-vol.org.uk/almanac2010>

Conclusions

This chapter identifies separate models of private delivery, and addresses the benefits that the private sector suppliers bring, with a view to indicating where long-term growth in the market may arise. A crude but useful taxonomy is given which boxes non-public provision of public services into three main categories: (i) full privatization (essentially an arm's-length relationship between provider and government); (ii) public-private partnerships (separated again into outsourcing partnerships and private finance initiative arrangements); and (iii) not-for-profit. The comparative merits of these are then explored and the general theme that emerges is that, on average, privatization and outsourcing partnerships have been successful, private finance initiative partnerships have brought benefits but it is difficult to be really sure and, in contrast, the view that not-for-profit is superior to for-profit delivery is unproven.

This picture should suggest that the private sector has a significant and growing role to play in the delivery of public services. But things are not this straightforward, because empirical evidence runs counter to public opinion. Surveys and focus groups show that private delivery is greeted with scepticism by the public. There appears to be two problems (although these are really the same thing viewed from two different angles). The public seem to think that private provision lacks the public service ethos that is deemed to be essential and that the profit motive is unacceptable in public services. In contrast not-for-profit delivery is growing rapidly and is perceived in a positive light. This conflict between what private delivery has to offer and what the public think of it and want from it is probably the biggest constraint on growth of private delivery mechanisms.